Commonwealth of Massachusetts
Department of Telecommunications and Energy

Investigation into the Provision of Default Service	)	**D.T.E. 02-40**

Initial Comments of the
Competitive Retail Suppliers

I. Introduction

AES NewEnergy, Centrica North America, Green Mountain Energy, Strategic Energy, and TXU Energy Retail Company LP (together "Competitive Retail Suppliers") submit these initial comments in response to the Department of Telecommunications and Energy's ("Department") June 21, 2002 request for comments.

AES NewEnergy, Inc.

AES NewEnergy, Inc. is a retail supplier serving commercial and industrial customers in thirteen states, including Massachusetts.

Centrica North America

Centrica North America encompasses the North American operations of Centrica plc ("Centrica").

Centrica is the leading supplier of energy and essential home and highway services for British consumers, employing approximately 30,000 people. Centrica's businesses include energy supply and home services under the British Gas and Scottish Gas brands; automobile services under the AA brand; insurance and financial services under the AA and Goldfish brands; and telecom services under the British Gas and

One.Tel brands. Worldwide, Centrica has approximately 44 million customer relationships. For the financial year ended December 31, 2001, Centrica reported sales of more than L 12.6 billion (US $17.6 billion).

Centrica entered the North American retail energy market in 2000. Since that time, through both organic growth and acquisitions, Centrica North America has grown to an enterprise with approximately 3.7 million customer relationships. In the United States, Centrica North America has, through its subsidiaries, become one of the largest multi-state providers of deregulated energy services, with more than 600,000 customers located principally in Georgia, Michigan, Ohio, Pennsylvania, and Texas. In April 2002, Centrica North America announced a deal with American Electric Power to acquire over 800,000 residential and small commercial electricity customers in Texas.

Green Mountain Energy Company

Green Mountain Energy Company is the nation's largest and fastest growing residential provider of cleaner electricity. Green Mountain Energy Company provides less-polluting electricity generated from sources including wind, solar, water, geothermal, biomass, and natural gas. Green Mountain Energy Company is currently serving people in seven states including California, Connecticut, New Jersey, Ohio, Oregon, Pennsylvania, and Texas.

Strategic Energy

Strategic Energy is an objective energy management company that provides electric load aggregation and power supply coordination services. Founded it 1985, Strategic has transformed itself from an energy consulting firm into one of the largest competitive retail energy providers in the United States. Strategic now has more than 26,000 nonresidential customers in states that have enacted retail choice including Pennsylvania, Ohio, New York, Massachusetts, Connecticut, Texas, California and Oregon. Strategic Energy procures and manages over $2 billion of electricity and natural gas per year.

TXU Energy Retail Company LP

TXU Energy Retail Company LP ("TXU") is one of the largest energy services companies in the world. Based in Dallas, Texas, TXU is part of a family of companies that is a global leader in electric and natural gas services, merchant energy, energy marketing, energy delivery, telecommunications, and other energy services. TXU delivers or sells electricity and natural gas to a total of 11 million customers, primarily in the United States, Europe, and Australia. TXU has 2.7 million retail electric customers in the United States, making it the country's largest retail provider of electricity to residential customers.

II. The Department should Articulate a Vision of the End-State that will Enable a Vibrant Competitive Market to Develop for all Customers.

A. The Department should Articulate a Vision and a Roadmap.

The impending end of the Standard Offer transition period gives Massachusetts a chance to implement true competition in electric supply service. The Department should seize the opportunity. It should learn from the successes and failures of restructuring to date. It should build on the successes and correct the failures, and thereby "ensure that the benefits of a competitive market are available to **all** Massachusetts consumers." Investigation into the Provision of Default Service, D.T.E. 02-40, p. 2 (June 21, 2002).

It is unrealistic to expect that the Department will be able to implement all of the needed reforms with one stroke of a pen. Some reforms may take a year to implement; others may require legislative change.

Therefore, the Department should articulate its vision of the end state, and a roadmap to get there. The Department should chart the course now that Massachusetts will follow to the end of the Standard Offer transition period and beyond. This vision will enable the competitive market to develop because competitive firms will invest more in this marketplace once they know where the state is headed.

B. Elements of the Vision.

The vision must be one that enables and sustains a vibrant competitive market. The Competitive Suppliers respectfully suggest that the vision must contain the following three elements:

First, default service prices must include all of the costs of providing default service. This includes both all generation costs and all retailing costs. Providing competitive electric service to customers involves more than wholesale "generation." Competitive service involves all aspects of retail electric supply. Hiding some of these costs in the distribution charge is misleading and may lead customers to make the wrong choices. Competition has invariably failed in jurisdictions that have hidden supply and retailing costs in distribution charges. Full implementation of this principle will require unbundling, and removal of all retail electric supply costs from distribution rates.

Second, the utility must exit the role of default service provider. Competition will not fully develop, and may not develop at all for small customers, as long as the utility remains in this role. Instead, default service should be provided by competitive retail suppliers. Implementation of this principle will require a retail auction or similar mechanism to move customers to competitive default service suppliers.

Third, in the end-state, billing should be performed by competitive retail suppliers rather than utilities. The bill is the primary means of communication with small customers; it should be provided by the competitive firm, not the monopoly. In light of current statutory limitations, the utilities should continue to perform billing for the short term. However, they should do so as a service to suppliers, including default providers, and should charge for that service pursuant to Department-approved tariffs.

III. The Creation of an Efficient Competitive Market Requires Different Approaches for Large and Small Customers.

As the Department recognized, the competitive market has developed differently for large and small customers. The market as currently structured has allowed competition to develop for large and medium commercial and industrial customers, but not for small commercial and residential.

The Department should implement Default Service reforms that take into account the characteristics of the different customers classes, the state of the competitive market for those classes, and the business realities of providing competitive service to those classes. For large and medium customers, default service should be an emergency or interim service that is provided by a competitive default service provider selected through a competitive bid process.

For the purposes of Default Service, customers should be divided as follows:

- Large C&I customers: accounts with demand > = 200 kW.
- Medium C&I customers: accounts with demand > = 10 kW and < 200 kW; accounts with demand < 10 kW with interval meters; accounts with demand < 10 kW that are associated with large customers.
- Small C&I customers: accounts with demand < 10 kW that do not fit into the medium category.

- Residential customers.

IV. Default Service Price Components.

It is fundamental that the price of default service must include all of the costs of providing the service. Failure to include all costs will doom the competitive market to failure. Unlike some other issues related to default service, pricing issues apply uniformly across all customer classes.[1]

The costs that must be included in the default service price include:

- Administrative costs
- Electric supply-related bad debt
- Electric supply-related customer service
- The full costs of price and volume risk
- The cost of preparing and distributing the disclosure label
- All supply-related costs
- Renewable Portfolio Standards compliance costs
- An allocation of billing costs
- An allocation of utility overheads (if the utility is the default service provider)
- Charges to reconcile default service costs with revenues
- The effects of locational marginal pricing ("LMP")[2]

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[1] Given small customers' low usage, however, the non-energy costs of providing service make up a relatively high percentage of the costs of serving them. Leaving these costs embedded in utility rates has all but precluded the possibility of price competition for small customers in Massachusetts to date, and will continue to do so. Thus, getting the pricing right, and moving all generation and retailing costs out of distribution rates, is critical for fully opening the retail market to these customers.

[2] There is no question that LMP costs should appear in the default service price. The alternative -- placing the costs in the wires charges -- would undermine the entire purpose of LMP. There is, however, a secondary question that arises for distribution companies that cover more than one LMP zone: should default service prices vary by zone or should those zonal price differences be socialized to enable one default service price across the territory? For large and medium customers, default service prices should reflect zonal variations. Competitive suppliers' price offers to these customers will reflect those variations;

Many of these costs can be identified today. They should be removed from distribution rates and placed in default service prices where they belong. To the extent that these costs cannot be readily identified and allocated today, the Department should initiate a proceeding to undertake that work.

One cost that should be immediately transferred to the electric supply portion of the bill is the Default Service Adjustment, currently paid by all customers. By shifting this cost to the electric supply portion of the bill, the true cost of having the utility arrange supply will be better evident to customers who remain with the utility.

V. Default Service Procurement

A. The Utility Must Exit the Role of Default Service Provider in order for an Efficient Competitive Market to Develop.

It will be necessary for the utility to exit the role of default service provider in order for an efficient competitive market to develop. When the monopoly delivery company serves as the default provider of a competitive service, it distorts in the marketplace and impedes the development of the competitive market. Therefore, all default service customers should be allocated to competitive retail suppliers, using mechanisms such as a retail auction.

While the barriers created by utility default service apply to all customer classes, many of them apply most acutely to small customers. They include the following:

Scale

It is expensive and inefficient to serve small numbers of customers. This is especially true for small customers because of the low usage per customer. Where the

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omitting them from default service prices would distort the market. However, the question is more difficult for residential and small commercial customers. The principle of reflecting costs in rates has equal power.

utility has been allocated all the customers on default service, a competitive supplier must pick up customers one-by-one. This creates a very slow path to efficient scale. Several suppliers of small customers that have taken this path have gone bankrupt. Most have chosen simply not to take it, and to stay out of the market in states that retain the utility in the role of default service provider.

A retail auction addresses this barrier because it enables suppliers to pick up large numbers of customers in a block. This gives the supplier instant scale and enables efficient operations from day one.

Acquisition cost

The cost of acquiring utility default service customers has proven to be very high. Competitive retailers must overcome both the customer's reluctance to leave the familiar utility for the relatively unfamiliar competitor, and the natural price advantage an incumbent monopoly has over its potential competitors. Even if all of the utility's costs to provide default service were included in the price, the default service price would not reflect any customer acquisition costs, since the utility obtained the customer through its position as the incumbent monopoly.

A retail auction enables the winning bidders to pick up a large number of customers at a low acquisition cost per customer. It may also tend to reduce acquisition costs for a second competitive supplier that seeks to win customers away from the competitive default service supplier. The winning bidder in an auction will not have the same unfair price advantage over competitors that is enjoyed currently by the utilities, as even the winning bid will reflect the winner's true cost to provide service, including

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However, there is a countervailing concern that charging different default service prices to residential customers within a single territory may cause customer confusion and dissatisfaction.

acquisition costs. Further, if the market structure encourages multiple suppliers to participate and advertise products and services, the vitality of the market will encourage switching and lower the cost of acquisition for all suppliers.

B. The Auction Must be a True Retail Auction, not a Wholesale Auction in Disguise.

To achieve the desired result, it is essential that the auction be a true **retail** auction – not a wholesale auction in disguise. Characteristics of a retail auction include:

- **Switching.** Customers are "switched" to the competitive retail supplier.
- **License.** Suppliers must be licensed, retail electric suppliers.
- **Customer Service.** Suppliers are responsible for generation related customer service.
- **Load Serving Entity.** Suppliers are the load serving entity and have all wholesale supply obligations.
- **Retail Obligations.** Suppliers are responsible for retail supply obligations, including disclosure label.
- **Billing.** Initially, billing is a service provided by the utility for the supplier, under a Department approved tariff that includes prices for both basic and enhanced billing services. Over time, billing becomes a supplier responsibility, which the supplier may contract with the utility to perform on the supplier's behalf.
- **End of the Term.** At the conclusion of the default service term, the competitive default service supplier has the option of either retaining the customers as competitive supply customers, or returning the customers to a pool for re-auction. If the supplier chooses to retain the customers, customers will be notified of the fact and can affirmatively choose to re-enter the auction pool.

VI. The Department has the Authority to Implement a Retail Auction of Default Service Customers

The Electric Utility Restructuring Act, Chapter 164 of the Acts of 1997, specifically grants the Department the authority to allow competitive suppliers to replace the utility as the default service provider. The Act provides as follows:

> The department may authorize an alternate generation company or supplier to provide default service, as described herein, if such alternate service is in the public interest.

M.G.L. c. 164 §1B(d).

Replacing the utility as the default service provider for small customers is in the public interest. There is a public interest in competition, and competition has not and will not develop for small customers as long as the utility is the default service provider.

The Legislature found that competition is in the public interest when it enacted the Electric Restructuring Act. The Act provides, in pertinent part, as follows:

> It is hereby found and declared that:
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> . . .
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> (c) **ratepayers and the commonwealth will be best served by moving** from (i) the regulatory framework extant on July 1, 1997, in which retail electricity service is provided principally by public utility corporations obligated to provide ultimate consumers in exclusive service territories with reliable electric service at regulated rates, **to (ii) a framework under which competitive producers will supply electric power** and customers will gain the right to choose their electric power supplier;
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> (d) **the existing regulatory system results in among the highest, residential and commercial electricity rates** paid by customers throughout the United States;
>
> . . .
>
> (f) the **introduction of competition in the electric generation market will encourage innovation, efficiency, and improved service** from all market participants, and will enable reductions in the cost of regulatory oversight;
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> (g) **competitive markets** in generation should (i) provide electricity suppliers with the **incentive to operate efficiently**, (ii) open markets for **new and improved technologies**, (iii) provide electricity buyers and sellers with **appropriate price signals**, and (iv) **improve public confidence** in the electric utility industry;
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> . . .

> (k) **long-term rate reductions can be achieved most effectively by increasing competition and enabling broad consumer choice** in generation service, thereby allowing market forces to play the principal role in determining the suppliers of generation for all customers;
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> (l) the primary elements of a more competitive electricity market will be **customer choice**, preservation and augmentation of consumer protections, **full and fair competition in generation**, and enhanced environmental protection goals;
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> (m) **the interests of consumers can best be served by an expedient and orderly transition from regulation to competition** in the generation sector consisting of the unbundling of prices and services and the functional separation of generation services from transmission and distribution services;
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> . . .
>
> Therefore, it is found that **it is in the public interest** of the commonwealth to promote the prosperity and general welfare of its citizens, a public purpose for which public money may be expended, by restructuring the electricity industry in the commonwealth to foster competition and promote reduced electricity rates through the enactment of the following statutory changes.

Electric Restructuring Act, §1 (emphasis added).

By using a retail auction, the Department can ensure that small customers are protected in the transition to a competitive default service provider. The price would be set through a competitive auction process, and the Department could establish the term and the terms and conditions of service. The retail auction model offers a smooth and protected transition for small customers.

Importantly, the Restructuring Act explicitly contemplates that Standard Offer customers will experience a significant change in their service at the end of the Standard Offer period. Those customers will be transferred from the stable Standard Offer with its rate cap to Default Service with prices that are uniform only for "periods up to six months"[3] and no rate cap. Transferring customers to competitive suppliers under terms and conditions approved by the Department is no more disruptive than what will happen to customers if the Department does nothing at all.

VII. Default Service Pricing and Terms of Service

A. Large Customers

For large customers, default service pricing and terms of service should change as of March 2005. There is no need to continue to offer default service with an unlimited term to these customers, who are the largest, the most sophisticated, and for whom the competitive market is functioning today.

Default service for these customers should become an "emergency" or "interim" service. The purpose of this service would be to cover customers that do not have a competitive supplier. It should be available only for a brief period while the customer finds a new supplier. The service should be provided by a competitive supplier chosen through a competitive process conducted by the utility or the Department. The price should account for all the costs and risks of providing the service.

B. Medium customers

The existing default service pricing and terms of service are working well for these customers. As the Department has pointed out, increasing numbers of medium customers are moving to the competitive market. This trend can be expected to continue as the market continues to develop.

Accordingly, default service pricing and terms of service should continue largely unchanged for medium customers. However, all appropriate costs should be moved into default service prices, as discussed in Section IV, Default Service Price Components.

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[3] M.G.L. c. 164, §1B(d).

As the competitive market develops further, default service should be modified for medium customers as it is for large customers. Default service should become an emergency or interim service.

C. Residential and Small Commercial Customers

Under a retail auction approach, it would be possible to give default service customers greater price certainty than they have today. For example, the retail auction model discussed at the Department's July 23 technical session would involve a fixed, two-year price. For those who see price volatility as a flaw in the current default service model, this should make the retail auction more attractive than the status quo.

The terms of service would be uniform for all customers and would be established by the Department as part of the design of the retail auction. In this way, the Department will be able to ensure that all necessary consumer protections are maintained.

VIII. Role of the Distribution Companies

In its Competitive Market Initiatives proceeding, D.T.E. 01-54, the Department has instituted many valuable reforms that are facilitating customer migration to the competitive market. These initiatives have focused on facilitating supplier access to customer information and facilitating customer enrollment by allowing Internet sign-ups. The Competitive Retail Suppliers applaud the Department for these efforts.

In this proceeding, the Department should go one step further. It should require the utilities to recognize the reality of the supplier/utility relationship and treat suppliers as what they are – **customers**.

Competitive suppliers are dependent on the utilities to provide numerous services, including metering, billing,[4] provision of customer information, and distribution of the suppliers' electricity to the suppliers' customers. Importantly, these are monopoly services. There is no alternative provider for suppliers to switch to when service is poor.

However, in the current arrangement, competitive suppliers are not treated as customers. The services a competitive supplier receives from a utility are paid for by end-users in distribution rates, not by suppliers directly, as in a vendor relationship. A utility's regulated return may be affected by the quality of distribution service it provides to end-users, but that return is not affected by the quality of service the utility provides to suppliers. The lack of any financial incentive on the utility's part to provide quality service to suppliers has been a barrier to improving the process by which competitive suppliers acquire and serve their customers.

The simple solution is for the utilities to begin treating competitive suppliers as what they are – customers. The utilities should provide services to suppliers under tariffs approved by the Department. Those tariffs should include pricing for both basic and optional enhanced services. And, the utilities' performance incentives/penalties should be based on their service to their supplier customers as well as their service to their end-user customers.

[4] As discussed elsewhere in these comments, the Competitive Retail Suppliers believe that certain of these services, particularly billing, should become competitive in the sense that suppliers, should be able to perform the services themselves. For the moment, however, these are monopoly services, both in that suppliers are not allowed to perform the services for end-use customers and in that suppliers are dependent upon a single provider – the regulated utility.

IX. Initial Implementation

At the Department's technical session, there was discussion of a "pilot" retail auction for existing small default service customers.

The Competitive Retail Suppliers strongly endorse the notion of conducting a retail auction for existing small default service customers as soon as possible. There is no need to wait for the end of the standard offer period to implement the program for existing default service customers.

However, the Competitive Retail Suppliers urge the Department not to implement a "pilot" program in the traditional sense of "let's try it on a small scale and then decide whether we want to do it for real." A pilot of that nature is unlikely to succeed, and may doom the entire program.

For the retail auction to succeed, competitive suppliers must be willing to invest in the infrastructure necessary to serve large numbers of small customers in Massachusetts. Suppliers will make these investments, and will participate aggressively in the auction if, but only if, the auction enables them to establish a long-term relationship with customers. It is only through such a long-term relationship that suppliers will be able to recoup their investment. If, on the other hand, the auction is simply a short-term test, with no clear expectation regarding the future, retail suppliers will not participate because the auction will offer no way for them to recoup their investment.

Massachusetts has been in a "transition period" to retail competition for over 5 years. It is time to end the transition and to get on with the real thing. The time for pilots is over.

X. Conclusion

The Competitive Retail Suppliers respectfully request that the Department adopt the foregoing recommendations.

Respectfully submitted,

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